

FINANCIAL MANAGEMENT ASSESSMENT

EXECUTIVE SUMMARY

The financial management assessment (FMA) focused mainly on fund flows, organization and staffing, accounting policies and procedures, internal controls, financial reporting and monitoring, internal and external audits, and information systems. The FMA also drew on lessons learnt from the ongoing Third Small Towns Water Supply and Sanitation Sector Project implemented by Department of Water Supply and Sewerage (DWSS), FMA questionnaires completed by DWSS and its project management office (PMO), and the Town Development Fund (TDF).

The DWSS has considerable experience in implementing Asian Development Bank (ADB) projects, including the ongoing third small towns project, which has been implemented at a satisfactory level in terms of receiving project funds in a timely manner, including the government's counterpart funds, efficient project management with adequate staff, timely submission of annual audited financial statements to ADB, and disbursements to contractors and consultants without delays.

The dedicated project director is being and will be assisted by a team of technical and non-technical officials to manage both the ongoing third small towns project and the proposed UWSSP on full time basis. The existing PMO of DWSS will be responsible for all day-to-day management of UWSSP, including but not limited to: (i) preparing an overall project implementation plan and detail work program; (ii) monitoring and supervising all management activities; (iii) preparing project progress and project completion reports; (iv) preparing financial and budget plans including contract awards and disbursements; (v) conducting project management and administration; (vi) procuring goods and works; (vii) recruiting contractors and consultants; (viii) making payment of 70% of civil works costs for water supply subprojects, 85% of civil works costs for sanitation subprojects, and all other costs include equipment and consulting services; (ix) retaining supporting documents; (x) completing all reporting requirements including the annual audit report and financial statements; and (xi) ensuring full compliance with ADB's resettlement, environmental, and other safeguard policies.

The TDF, the financial intermediary established by Government of Nepal, will be responsible for providing loan, equivalent to 25% of civil work costs for water supply subprojects, to the water user' and sanitation committees (WUSCs) which are currently in the process of establishment. The TDF will also support WUSCs in handling project accounts and financial management during the implementation and loan repayment period.

The major risk factors identified during the assessment that need to be addressed include:

- (i) delays in full establishment of dedicated WUSCs with qualified staff may hamper the timely and effective implementation;
- (ii) lack of training to new accounting staff of PMO may cause delays in preparing day-to-day financial management; and
- (iii) inadequate staff in the finance section of TDF may hamper the timely preparation and submission of periodic financial reports.

Despite the highlighted risks, the financial management arrangements are satisfactory taking the ongoing actions of DWSS, PMO, and TDF into consideration. The overall risk assessment for UWSSP is "Moderate". In addition, DWSS, PMO, and TDF will be supported by a team of consultants for project management, design, supervision, and monitoring as well as policy and regulatory related matters. At the central level, a Project Coordination Committee, chaired by the

Secretary of Ministry of Water Supply, will provide overall direction on the planning and implementation of UWSSP and coordination arrangements with related ministries. The action plan for mitigating the foreseen risks includes the following measures:

- (i) commitment of the Government of Nepal and DWSS to ensure the timely establishment of WUSCs with qualified staff;
- (ii) extending full training and capacity building support with the help of a team of consultants to enhance the financial management capacity of PMO; and
- (iii) appointing or recruiting qualified staff to fill the vacant positions in the finance section of TDF.

I. INTRODUCTION

1. This financial management assessment (FMA) was prepared in accordance with Asian Development Bank (ADB) Guidelines for the Financial Management and Analysis of Projects (2005),¹ Financial Due Diligence a Methodology Note (2009),² and Financial Management Technical Guidance Note (2015)³ focusing on fund flows, staffing, accounting policies and procedures, internal controls, financial reporting and monitoring and internal and external audits.

2. The FMA considered the capacity of (i) Department of Water Supply and Sewerage (DWSS) under Ministry of Water Supply (MOWS) as implementing agency, and (ii) the Town Development Fund (TDF) as financial intermediary.

3. The MOWS will execute Urban Water Supply and Sanitation (Sector) Project (UWSSP) on behalf of the Government of Nepal (the government), working through the DWSS. The DWSS will strengthen the existing project management office (PMO) for the ongoing Third Small Towns Water Supply and Sanitation Sector Project (third small towns project)⁴ and the DWSS's Institutional Support and Service Advisory Unit (ISSAU) and regional PMOs (RPMOs). The DWSS will depute adequate staff and allocate adequate budget to PMO, ISSAU, and RPMOs. Further, it will also regulate water user' and sanitation committees (WUSCs) and provide them with full technical, financial, and institutional support. In addition, it will select subprojects based upon the agreed subproject selection criteria for UWSSP.

4. The PMO is responsible for overall project management, implementation, and monitoring. It coordinates with ADB and other agencies at central level for the implementation of UWSSP. It is also responsible for handling the grant fund payable to the contractors, consultants, and other stakeholders, consolidating the project accounts, auditing the consolidated financial statements for further submission to ADB, and handling the reimbursement claims. It will also provide capacity building to TDF, WUSCs, and municipalities in handling the financial management.

5. The TDF, the financial intermediary established by the government, will be responsible for providing loan, equivalent to 25% of civil work costs for water supply subprojects, to the WUSCs⁵ which are currently in the process of establishment. The TDF will also support WUSCs in handling project accounts and financial management during the implementation and loan repayment period.

6. A key aspect of FMA is evaluating the risks associated with financial arrangements of UWSSP. ADB's principal concern is to ensure that investment funds are used economically and efficiently for the purpose intended. In support of this, it seeks assurance that the financial management systems of the executive agency and implementing agency can report on the source and use of funds of the UWSSP. The assessment was based on the results of the FMA questionnaire, discussions with officials of DWSS, PMO, and TDF. Information was also collected

¹ ADB. 2005. *Financial Management and Analysis of Projects*. Manila.

² ADB. 2009. *Financial Due Diligence A Methodology Note*. Manila.

³ ADB. 2015. *Financial Management Technical Guidance Note*. Manila.

⁴ ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Third Small Towns Water Supply and Sanitation Sector Project*. Manila.

⁵ The Water Users and Sanitation Committee is an elected body in each project municipality to manage the water users' association formed by the users under the Drinking Water Regulation 1998. WUSCs will be responsible for project preparation and implementation along with DWSS. WUSCs will also operate and maintain the assets developed under UWSSP in each project municipality once UWSSP is completed. WUSCs will contribute 30% of civil works costs for water supply subprojects (25% from TDF loan and 5% from users' contribution) and 15% of civil works costs for sanitation subprojects (subsidy from municipalities).

through various reports, including audit reports of previous ADB projects implemented through the DWSS.

7. This FMA was conducted to (i) assess executing agency capacity to monitor, manage and support the overall project; (ii) assess implementing agency capacity to implement and manage investments; and (iii) propose ways and means to strengthen the capacity of executing and implementing agencies. Specifically, the objective is to enhance competence levels to achieve the government's goals of improving urban infrastructure in water supply and sanitation (WSS), improving access to and the level of service for WSS, and strengthening institutions and building capacity to strengthen the operations and maintenance skills of WUSCs.

II. BRIEF PROJECT DESCRIPTION

8. The UWSSP aims to enhance access to improved WSS services in urban areas of project municipalities.⁶ The UWSSP will finance physical investments in WSS facilities and non-physical investments to improve service regulation, monitoring and governance, and user participation in the WSS sector in selected municipalities.

9. Through physical investments, the UWSSP will replicate successful cases from the ongoing ADB funded third small towns project. Through non-physical investments, the UWSSP will strengthen the capacity of key institutions in the urban WSS sector including an advanced project design mechanism for future infrastructure investments. The UWSSP will include the following outputs: (i) water supply and sanitation infrastructure in project municipalities improved, and (ii) institutional and community capacities strengthened.

III. COUNTRY FINANCIAL MANAGEMENT ISSUES

10. Nepal's legal and regulatory framework for ensuring public sector financial accountability is specified in constitutional provisions of the Office of the Auditor General (OAG), the Commission for Investigation of Abuse of Authority, and the Public Accounts Committee. The Financial Procedures Act and Financial Administration Regulation specify comprehensive provisions for budget preparation and approval, accounting and reporting, and internal control mechanisms. The Local Government Operation Act 2017 and Local Government Budget Preparation and Implementation, Financial Management, and Property Transfer Guideline 2017 provide regulations for financial accountability at the municipalities.⁷ The project completion report by ADB on Nepal: Strengthening Public Management Programme (2018)⁸ reports the gradual improvement in the fiduciary risk reduction both at national and sub-national level of the governments due to results-based capital expenditures, external audits, and the e-Government Procurement (e-GP) system.

11. Constitution of Nepal, promulgated in 2015, and the federal governance system are in place of unitary governance system. The state reconstruction process may cause significant changes in existing service delivery, instructional mechanism, and financial management system

⁶ Previously referred to as small towns, which were defined as towns with (i) population of 5,000 to 40,000; (ii) located on a road linked to the strategic road network; (iii) has perennial road access, grid power, telecommunication, and potential for growth; (iv) has an average population density of 10 persons per hectare; and (v) has jurisdiction of one administrative boundary. These criteria will remain for subproject selection in project municipalities.

⁷ Government of Nepal, Ministry of Federal Affairs and General Administration. 2017. <http://www.mofald.gov.np/en/node/2738>

⁸ ADB. 2018. *Project Completion Report*. Manila. <https://www.adb.org/sites/default/files/project-documents/36172/36172-063-pcr-en.pdf>

of the country. However, WSS is the joint responsibility of the federal, provincial, and municipalities.

12. The Country Partnership Strategy for Nepal, 2013-2017 identified risks relating to country governance. It cited Public Financial Management (PFM), public procurement, and corruption and prepared a risk management plan by following the Second Governance and Anticorruption Plan framework and guidelines. Major risks and risk management plan prepared in the country partnership strategy are indicated in Table 1.

Table 1: Governance Strategy – ADB County Partnership Strategy (Key Risks and Risks Management Plan Related to Public Financial Management and Corruption)

Major Risks	ADB Actions
A. Public Financial Management	
Budget execution follows elaborate and complex processes, leading to an uneven pace of expenditure.	<ul style="list-style-type: none"> Engage with the government to make budget execution smooth by simplifying procedural matters in PFM, such as authorization, procurement plan, annual program approval, contract timing, and timely reportage; and Put in place a Medium-Term Budget Framework for MOFALD.
Accounting system not able to provide a fair, accurate and timely picture of public finances.	<ul style="list-style-type: none"> Engage with the government and other Development Partners on speedy implementation of NPSAS and fully operationalization of within FCGO; and Provide support to FCGO.
Lack of capacity of relevant central and local level bodies in all aspects of PFM.	<ul style="list-style-type: none"> Provide targeted technical assistance support to relevant bodies; Help finalize the PFM protocols and assist agencies to finalize relevant capacity building plans; and Assist in following through on capacity building plans.
Ineffective internal controls, audit, monitoring and evaluation systems.	<ul style="list-style-type: none"> Provide support to strengthen capacity of internal auditing system; and Build capacity of OAG and Public Accounts Committee to follow up irregularities.
Final auditing system not able to function effectively due to time and quality issues.	<ul style="list-style-type: none"> Explore the possibility of concurrence audit with the government and Development Partners; Working with other Development Partners, provide necessary support to OAG for conducting final audits on time; and Encourage OAG to roll out risk-based auditing more widely.
Fiscal transparency low at all levels.	<ul style="list-style-type: none"> Ensure timely and regular public access to budget documents. Build demand for seeking fiscal information; and Provide TA support for enhancing fiscal transparency on a sustainable basis.
B. Combating Corruption	
Low capacity of central agencies and municipalities to investigate corruption cases and to implement the rules and regulations in place.	<ul style="list-style-type: none"> Engage with the government to maintain political support for the anticorruption agenda; Ensure some levels of support to municipalities to review good governance practices in ADB projects and programs; and Coordinate with Development Partners on provision of needed technical assistance so as to maximize impact.
Weaknesses in audit provisions and follow-up at all levels of administration.	<ul style="list-style-type: none"> Provide needed technical assistance on audit provisions to relevant agencies (OAG, Public Accounts Committee, municipalities, etc.); and Engage with government to continue to emphasize follow up on audits.

Major Risks	ADB Actions
No institutional presence of anticorruption agencies at the local level.	<ul style="list-style-type: none"> • Help assess the extent of need of institutional presence of relevant anticorruption agencies, particularly CIAA, at the local level; • Assess existing provisions on District Administration Office work on anticorruption, and provide technical assistance as needed; and • Strengthen existing auditing and other control provisions at local level.
Weak whistle-blowing provisions.	<ul style="list-style-type: none"> • Review existing provisions and ascertain gaps; • Assess whether similar provisions can be built into other existing laws; • Strengthen grievance handling mechanisms in government institutions and in-service delivery agencies; and • Organize seminars and workshops on ethical values and provide technical assistance to establish public complaint systems.

CIAA = Commission for Investigation of Abuse of Authority; FCGO = Financial Comptroller General's Office; MOFALD = Ministry of Federal Affairs and Local Development; NPSAS = Nepal Public Sector Accounting Standards; OAG = Office of the Auditor General; PAC = Public Accounts Committee; PFM = Public Financial Management. Source: Asian Development Bank. *Country Partnership Strategy: Nepal, 2013–2017*.

IV. OVERALL AND COMPARATIVE PERFORMANCE OF THE GOVERNMENT'S PUBLIC FINANCIAL MANAGEMENT SYSTEM

13. The government addressed these weaknesses through the introduction of a Treasury Single Account System, preparation of Nepal Public Sector Accounting Standards (NPSAS), development of a computerized government accounting system, and capacity development through training, workshops and studies.

14. The second Public Expenditure and Financial Accountability (PEFA) Assessment was conducted in 2014 based on the data from FY2011-2012 to FY2013-2014. This assessment highlighted progress achieved in the areas of financial management information systems, treasury systems including the Treasury Single Account System, NPSAS, planning and budgeting, accounting and reporting, adoption of Government Finance Statistics Standards, taxation, audit, procurement, external oversight, accountability and foreign aid management. Table 2 provides a summary.

15. Out of 31 major PFM indicators, there were upgrades in 19 indicators (61%) and downgrades in 2 indicators (7%), while 10 indicators (32%) remained constant. There was only one indicator with "A" grade in the first assessment improved to nine indicators grading "A" in second assessment. It is clear that many of the improved scores can be attributed to various government initiatives. However, the assessment has pointed out some discrepancies in budget formulation and execution, internal control, internal audit and oversight, accounting, recording and reporting, procurement, debt, revenue and investment management, access to information, human resource management and capacity development, payroll control and pension management, usage of financial management information systems, foreign aid management, and monitoring and evaluation.

Table 2: Summary of Public Expenditure and Financial Accountability Rating

Public Financial Management Performance Indicators	2008	2014	Comparable Scores	Change since 2008
I. Credibility of the Budget				
PI-1: Aggregate expenditure out-turns compared to original approved budget	B	A	Yes	Variances reduced
PI-2 Composition of expenditure out-turns compared to original approved budget	C	C+	Changed methodology	No direct comparability
PI-3 Aggregate revenue out-turns compared to original approved budget	A	A	Changed methodology	Performance unchanged
PI-4: Stock and monitoring of expenditure payment arrears	D+	B+	Yes	Stock of arrears below 2% and system in place
II. Comprehensiveness and Transparency				
PI-5 Classification of the budget	C	A	Yes	Expanded budget classifications
PI-6 Comprehensiveness of information included in the budget documentation	B	A	Yes	Performance improvement
PI-7 Extent of unreported government operations	C	D+	Yes	Higher proportion of extra budgetary operations than before
PI-8 Transparency of Inter-Governmental Fiscal Relations	C	C+	Yes	Sub national government's fiscal data reporting strengthened
PI-9 Oversight of aggregate fiscal risk from other public sector entities	D+	C	Yes	Performance improves
PI-10 Public access to key fiscal information	B	A	Yes	Performance improved
III. Policy-Based Budgeting				
PI- 11 Orderliness and participation in the annual budget process	C+	B	Yes	Issuance and adherence of budget discussion as per budget calendar
PI- 12 Multi-year perspective in fiscal planning, expenditure policy and budgeting	C+	B	Yes	Debt Sustainability Analysis conducted annually
IV. Predictability and Control in Budget Execution				
PI- 13 Transparency of taxpayer obligations and liabilities	C+	A	Yes	Performance improved
PI- 14 Effectiveness of measures for taxpayer registration and tax assessment	C	A	Yes	Overall improvement in taxpayer registration and tax assessment
PI- 15 Effectiveness in collection of tax payments	D+	D+	Yes	Performance unchanged
PI- 16 Predictability in the availability of funds for commitment of expenditures.	C+	C+	Yes	Performance unchanged
PI- 17 Recoding and management of cash balances, debt and guarantees	C+	C+	Yes	Performance unchanged
PI- 18 Effectiveness of payroll controls	C+	C+	Yes	Performance unchanged.
PI- 19 Competition, value for money and controls in procurement	C	B	Yes	Use of open competition
PI- 20 Effectiveness of internal controls for non-salary expenditures.	C	C	Yes.	Performance unchanged
PI- 21 Effectiveness of internal audit	D+	D+	Yes	Performance unchanged

Public Financial Management Performance Indicators	2008	2014	Comparable Scores	Change since 2008
V. Accounting Recording and Reporting				
PI- 22 Timeliness and regularity of accounts reconciliation	C+	C+	Yes	Performance unchanged
PI- 23 Availability of information on resources received by service delivery units	C	A	Yes	Improvement on resources made available to service delivery units
PI- 24 Quality and timeliness of in year budget reports	C+	C+	Yes	Performance unchanged
PI- 25 Quality and timeliness if annual financial statements	C+	C+	Yes	Performance unchanged
VI. External Scrutiny and Audit				
PI- 26 Scope, nature and follow-up of external audit	D+	C+	Yes	Audit coverage expanded and timely submission of audit reports
PI- 27 Legislative scrutiny of annual budget law	D+	D	Yes	No parliament
PI- 28 Legislative scrutiny of external audit reports	D	D	Yes	No parliament
D. Donor Practices				
D-1 Predictability of Direct Budget Support	D	D+	Yes	Improvement in timeliness
D-2 Financial information provided by donors for budgeting and reporting on project and program aid	D	C+	Yes	Improvement in donor information
D-3 Proportion of aid that is managed by use of national procedures.	D	C	Yes	Greater use of national procedures

PFM = Public Financial Management

Source: Nepal PFM Performance Assessment – II as of FY2013/14. Government of Nepal. Ministry of Finance.

16. **Reform Strategy.** The government has formulated Nepal's Public Financial Management Reform Strategy - Phase II for the periods of FY2016-2017 to FY2025-2026 based on the strengths and weakness identified in the second PEFA assessment. The strategy is prepared taking account of on-going reform program of the government in areas such as further enhancement of the Treasury Single Account systems, strengthening accounting and reporting practices (NPSAS) and strengthening PEFA Secretariat. There are all together 119 reform action plans identified and developed on the basis of the recognized PFM performance gaps observed from the second PEFA assessment.

V. PROJECT FINANCIAL MANAGEMENT SYSTEM

1. Department of Water Supply and Sewerage and Project Management Office

17. **Overview.** The DWSS is the lead agency of WSS sector in Nepal and is responsible for provision of WSS facilities in rural areas and small towns where dedicated utilities do not exist. The DWSS is also responsible for monitoring tariffs and supporting local bodies such as municipalities and WUSCs in WSS service delivery. The DWSS will (i) strengthen the existing PMO; (ii) strengthen its Institutional Support and Service Advisory Unit (ISSAU) and two regional PMOs (RPMOs); (iii) depute adequate staff in PMO, ISSAU, and RPMOs; (iv) sign management agreement with WUSCs and municipalities; (v) allocate adequate budget to PMO; (vi) regulate WUSCs and provide them with full technical, financial and institutional support; and (vii) select

subprojects based upon the agreed subproject selection criteria. The existing PMO for the ongoing third small towns project will also implement UWSSP.

18. The existing PMO will be responsible for all day-to-day management of UWSSP, including but not limited to: (i) preparing an overall project implementation plan and detail work program; (ii) monitoring and supervising all management activities; (iii) preparing project progress and project completion reports; (iv) preparing financial and budget plans including contract awards and disbursements; (v) conducting project management and administration; (vi) procuring goods and works; (vii) recruiting contractors and consultants; (viii) making payment of 70% of civil works costs for water supply subprojects, 85% of civil works costs for sanitation subprojects, and all other costs include equipment and consulting services; (ix) retaining supporting documents; (x) completing all reporting requirements including the annual audit report and financial statements; and (xi) ensuring full compliance with ADB's resettlement, environmental, and other safeguard policies.

19. **Major experiences of managing externally financed projects.** The DWSS is experienced in managing ADB financed projects. It has completed the ADB-funded first and second Small Towns Water Supply and Sanitation Projects in 29 and 21 towns, respectively. The ADB-financed third small towns project is currently under implementation in 20 towns.

20. **Funds flow arrangements.** Based upon the fund requirement request, DWSS is getting budget allocation from the government on annual basis. Similar procedure is followed for PMO.

21. Based on the funds requirement for UWSSP, PMO will present the request and accordingly budget will be allocated through the national budget. From the national budget, grant fund will be paid to the contractors and consultants through PMO or RPMOs. The government will pre-finance the ADB share of funds. To facilitate the cash flow of the government, the DWSS through the PMO will establish an advance account in USD at the Central Bank (Nepal Rastra Bank). The PMO will withdraw money from this account periodically to reimburse funds provided by the government.

22. In case larger amounts need to be payable to the contractors, PMO will submit withdrawal applications to ADB for direct payment. Since DWSS has been successfully implementing the ADB funded small towns projects, it has experience with the operation of an advance account and statement of expenditure procedures. The government loan and grant accounts are maintained in Ka-7-17⁹ and Ka-7-15¹⁰ respectively. This is the procedure followed for the earlier and ongoing projects and the same will be followed for UWSSP.

23. **Staffing.** The Financial Administration Section of DWSS, headed by a Under Secretary with five account officials, oversees the major financial management functions.

24. The regular financial administrative functions of UWSSP at the PMO will be carried out by a separate financial administration unit, headed by a Under Secretary and supported by one account officer and one accountant. This section is further supported by two consultants. Each RPMO is staffed with one account officer and one account assistant who are responsible for financial administration. Thus, there are 7 staffs in PMO and RPMOs that are supported by two other staffs on contractual basis. The current staff arrangement is considered appropriate for UWSSP. Account staffs of PMO are permanent staffs of the central government (civil service)

⁹ Name of government grant account.

¹⁰ Name of government loan account.

deputized by the Financial Comptroller General's Office (FCGO). However, the accounts staff, both in DWSS and PMO, are transferred to different assignments every two years, therefore, the continuity of the financial management process of UWSSP may be hampered and a re-orientation for the new staff is required.

25. **Accounting policy and procedures.** The accounting standards followed are defined by the FCGO and Office of the Auditor General (OAG) of Nepal. The DWSS is following the same national government accounting policies and procedures as directed by the FCGO and the same is followed in PMO.

26. The PMO will prepare the financial statements for both the government (FCGO and OAG) and ADB. The Financial Procedures Act and Rules, and the Procurement Act and Rules cover all routine financial management and related administrative matters.¹¹ A project management manual including accounting and financial reporting is available to provide guidelines for project financial management. Thus, the existing system in the PMO will be followed for UWSSP.

27. **Segregation of duties.** An adequate procedure for segregation of duties is available in the DWSS. Also, the existing organizational systems of PMO ensures adequate segregation of duties. While the store unit is responsible for ordering and receiving the required equipment and services, the accounts section is in charge of accounting and reporting. The Project Director will be responsible for authorization of payments and supervision of store management.

28. **Budgeting system.** The annual budget requirements prepared by the financial administration section of DWSS will be sent to the MOF. Based on the request, annual budget allocations will be made for DWSS operations.

29. The Project Director, in coordination with the concerned Deputy Project Director and accounts section of the PMO, is responsible for preparing budgets. The MOF will allocate necessary ADB loan and counterpart funds for project activities based on the request of the PMO. Budgets are prepared for all significant activities and provide benchmarks for budget variance analysis. Actual expenditures are compared with the budget before each transaction.

30. **Payments.** Payments are made against the invoices submitted for the payment and the verification system is established. Verified and certified documents will be sent to the treasury office of DWSS for payment. This system is followed in both DWSS and PMO.

31. **Cash and bank.** The DWSS accounts are maintained by the treasury office. The Project Director is responsible for payments in PMO. The accounts section ensures reconciliation of all accounting records. Due to adaptation of single treasury system, concerned District Treasury Controller Office (DTCO) is responsible for bank reconciliation.

32. **Safeguard over assets.** Store units in the DWSS and PMO are responsible in keeping records of fixed assets and stocks. In PMO, the annual assets valuation (stock check) system is in place and a team of three (deputy director, store chief, and accountant) of PMO carries out periodic physical verification of fixed assets and stocks. Only vehicles and motorbikes are covered by insurance policies.

¹¹ Public Procurement Act, 2063 (2007); Public Procurement Rules, 2064 (2007); Financial Procedure Act, 2055 (1999); Financial Procedure Rules, 2064 (2008).

33. **Contract management.** The PMO will be responsible for procurement of consultants, works, and goods. The PMO will procure consultants for project implementation support and goods such as vehicles and equipment. The RPMO will also procure works and goods to implement project activities. The PMO will make payments for the procurement of consultants and goods, while RPMOs also make payments for contractors based on the activities performed under the scope of UWSSP.

34. **Internal audit (Entity and Project Accounts).** Internal audits of DWSS and PMO are performed by the DTCO as per requirement, who prepares audit report. Internal audit of DWSS and PMO were completed up to FY2016-2017 and found satisfactory in compliance of audit comments.

35. **External audit (Entity and Project Accounts).** The OAG is a constitutional independent body responsible to carry out statutory audit of the government transactions. Accordingly, external audit for DWSS is carried out by OAG and audit up to FY2016-2017 was completed.

36. The statutory audits of the project account are conducted after the end of each fiscal year by the staff appointed by the OAG. External audit of the project account for the third small towns project was completed up to FY2016-2017 and also found satisfactory in compliance of audit comments.

37. **Reporting and monitoring.** The DWSS, as a government department, follows the government procedures in preparing reports for monitoring. The PMO prepares monthly and annual financial reports together with supporting schedules based on the government's accounting standards. The reporting system follows the international financial reporting standards. Since the financial reporting system compares budget with actual expenditure, it provides information for management decision-making. The PMO uses spreadsheets to prepare the reports. A progress report shows physical progress against the target and links financial information with physical progress. The same procedure will be followed for UWSSP.

38. **Information systems.** The DWSS has an automated information system, which PMO will use for preparing separate financial statements for UWSSP.

2. Town Development Fund

39. **Overview.** By the Town Development Act 1997, the TDF is functioning as a financial intermediary for urban development projects. It provides financial support to municipalities and emerging local bodies to implement social and income generating projects. It also supports to strengthen the technical, managerial, and financial capabilities of municipalities and WUSCs in implementation of urban development projects.

40. Under UWSSP, the TDF provides loan (up to 25% of civil works costs for the water supply subprojects) to the project WUSCs, if considered financially feasible, collects repayment from WUSCs, and pays back to the MOF. TDF's activities under UWSSP also include the following; (i) support WUSCs in tariff setting, financial management, and capacity building; (ii) management of institutional development and implementation support consultants; (iii) conduct of field review missions, midterm review missions, and project completion review missions to assess project implementation progress and compliance of loan covenants; and (iv) review of PMO's

submissions for procurement of goods, civil works and services. The TDF is associated in ADB funded small towns projects since 2000.¹²

41. **Funds flow arrangements.** After the on-lending agreement for subprojects is carried out between TDF and the participating WUSCs, the government will disburse the loan amount to TDF. The TDF shall be responsible for repaying the loan to government, and WUSCs shall be responsible for repaying the loan component to TDF. This is the procedure followed for the earlier and ongoing small towns projects and the same will be followed for UWSSP.

42. **Staffing.** The financial management of TDF is headed by a Manager who is supported by one senior financial officer and four account staffs. Presently, the manager position is vacant. Also, with the increasing accounting activities for ensuing projects, the need for additional account staffs are recognized. The TDF has already initiated activities to recruit staffs including for accounts and to fill the vacant positions.

43. **Accounting policy and procedures.** Similar to other government organizations, the TDF is following the national accounting system. It has initiated to implement international financing reporting system from the year of 2009 to suit the requirements of multilateral funding agencies. The TDF has successfully handled the loan portion of earlier projects in small towns and other parts of Nepal including the ongoing third small towns project funded by ADB. Financial transactions are accounted on accrual basis of accounting following generally accepted business accounting practices. The TDF has adequate policies and procedures governed by the (i) TDF Act, (ii) Financial Regulation, (iii) Financial Management By-laws, (iv) Loan and Grant Policy, (v) Employees Service Byelaws, and (vi) Accounting Manual.

44. **Internal audit (Entity and Project Accounts).** There is no Internal Audit Unit at TDF. The internal audit for entity and project accounts are being conducted by qualified and experienced internal auditors hired by the TDF Board on a contractual basis. The internal audit of entity and project level accounts are completed up to FY2016-2017, and also found with no major audit comments.

45. **External audit (Entity and Project Accounts).** External Audit of TDF and the project accounts are conducted by an independent "class A" registered auditor appointed by the TDF Board as per the recommendation of the OAG in accordance with the TDF Act 1997. The external audit of entity and project accounts were completed up to FY2016-2017, and also found with no major comments.

46. **Reporting and monitoring:** The TDF prepares financial statement of the entity and project accounts using MBS and spreadsheets. It comprises balance sheet, profit and loss account, cash flow statement, and supporting schedules. This procedure will be followed for UWSSP as well.

47. **Information systems:** TDF's MBS and MIS provide required information for financial reporting as well as management decision.

¹² ADB. 2000. *Report and Recommendation of the President to the Board of Directors: Small Towns Water Supply and Sanitation Sector Project*. Manila; ADB. 2009. *Report and Recommendation of the President to the Board of Directors: Second Small Towns Water Supply and Sanitation Sector Project*. Manila; and ADB. 2014. *Report and Recommendation of the President to the Board of Directors: Third Small Towns Water Supply and Sanitation Sector Project*. Manila.

VI. RISK ASSESSMENT

48. The FMA reviewed two types of risks: (i) inherent risks, i.e. risks outside the direct control of the executing and implementing agencies' financial management; and (ii) control risks, i.e. risks concerning the internal functioning and control of the executing and implementing agencies' finance and accounting section. The FMA identified the following key risks:

Table 3: Risk Analysis

Risk	Risk Assessment	Risk- Mitigation Measures
A. Inherent Risks		
1. Country-specific risks (Nepal)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> • Nepal is currently in the process of state restructuring based on the new constitutional provisions. • The state restructuring process may cause changes in existing public service delivery mechanism and financial management system of the country. • In such situation, the existing linkage and coordination mechanism between local to central and vice-versa may be changed. 	The Government of Nepal and ADB should continue the policy dialogues through various occasions including the country partnership strategy and the country operations business plan.
2. Entity-Specific Risks (DWSS)	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • MOWS is the executing agency, and DWSS the implementing agency. PMO established in DWSS is using the accounting system and procedures prescribed by the government. • The system followed for earlier and ongoing ADB funded projects will be followed for the project. 	Not applicable.
3. Project-specific risks	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> • The project aims to provide improved water supply and sanitation services. • Delays in establishing WUSCs may hamper timely project implementation. 	Timely establishment of WUSCs to be committed by Government of Nepal.
Overall Inherent Risk	<p style="text-align: center;">Moderate</p> <p>While country- and project-specific risks exist, these risks might be mitigated through cordial efforts of the Government of Nepal with support of ADB. Timely establishment of WUSCs with qualified staff particularly needs to be committed by Government of Nepal.</p>	
B. Control Risks – DWSS and PMO		
1. Implementing entity	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • DWSS will be responsible for the implementation of the project. • DWSS has implemented several ADB funded projects, including the ongoing third small towns project. • The existing PMO for the ongoing third small towns project will continue for project implementation. 	Not applicable.
2. Flow of Funds	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • Government of Nepal will allocate ADB loans and its counterpart funds to PMO and TDF using the established budgetary mechanism. 	Not applicable.

Risk	Risk Assessment	Risk- Mitigation Measures
	<ul style="list-style-type: none"> WUSCs will allocate their contribution through advance payment collected from the users. Funds flow for the project will be same as for the ongoing ongoing third small towns project. 	
3. Staffing	<p style="text-align: center;">Low (DWSS)</p> <ul style="list-style-type: none"> DWSS accounts section is adequately staffed with competent and experienced personnel. <p style="text-align: center;">Significant (PMO)</p> <ul style="list-style-type: none"> PMO, established for the ongoing ongoing third small towns project, will implement the project. Staff transfer every 2 years may hamper the timely implementation of the project. 	Extending full training and capacity building support are required for the newly assigned staff of PMO.
4. Accounting policy and procedures	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> DWSS and PMO follow established policies and procedures defined by the FCGO and the OAG of Nepal. 	Not applicable.
5. Internal audit	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> Internal audits of DWSS and project accounts are conducted by DTCO. Internal audits of DWSS and PMO have been done up to FY 2016-2017 without any delays. 	Not applicable.
6. External audit (entity)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> External audit of DWSS is conducted annually by OAG according to Nepalese Auditing Standards. External audit of DWSS has been done up to FY2016-2017 without some delays. 	DWSS will ensure timely submission of AFS.
7. External audit (project)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> External audit of project accounts is also conducted annually by OAG according to Nepalese Auditing Standards. External audit of the project account for the ongoing third small towns project for FY2015-2016 was qualified and for FY2014-2015 was unqualified. External audit of the project account for the ongoing third small towns project has been done up to FY2016-2017 with some delays. 	DWSS will ensure timely submission of annual external audit of project accounts and will ensure resolution of any audit issues.
8. Reporting and monitoring	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> The existing system functioning at satisfactory level will be followed for the project. 	Not applicable.
9. Information system	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> PMO uses a computerized accounting system. 	Not applicable.
Overall Control Risk	<p style="text-align: center;">Moderate</p> <p>Some financial management risks are recognized, but all of them are not high. However, extending training to new staff on ADB procedures needs to be ensured by DWSS and PMO.</p>	
C. Control Risks – TDF		
1. Implementing entity	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> TDF will be responsible for providing loans to WUSCs up to 25% of civil works costs for water supply subprojects. TDF has experience in managing ADB funded small towns projects as a financial intermediary. 	Not applicable.
2. Flow of Funds	<p style="text-align: center;">Low</p>	

Risk	Risk Assessment	Risk- Mitigation Measures
	<ul style="list-style-type: none"> MOF will disburse 25% of civil works costs for water supply subprojects to TDF. Then, TDF will provide this to WUSCs as loan. Funds flow for the project will be same as for the ongoing third small towns project. 	Not applicable.
3. Staffing	<p style="text-align: center;">Substantial</p> <ul style="list-style-type: none"> A manager responsible for financial management of TDF is currently vacant. Additional staff is required for the new projects including UWSSP. 	TDF needs to ensure filling up of vacancies and recruit new staff with qualification.
4. Accounting policy and procedures	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> TDF follows the accounting and financial reporting system of Government of Nepal and ADB. TDF has adequate policies and procedures governed by the TDF Act and Regulation, Financial Management By-laws, Loan and Grant Policy, Employees Service By-laws, and Accounting Manual. 	Not applicable.
5. Internal audit	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> The internal audit of TDF is being conducted by qualified and experienced auditors hired by the TDF Board on a contractual basis (completed up to FY 2016-2017). 	Not applicable.
6. External audit (entity)	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> External Audits of TDF are conducted by an independent “class A” registered auditor appointed by the TDF Board (completed up to FY 2016-2017). 	Not applicable.
7. External audit (project)	<p style="text-align: center;">Moderate</p> <ul style="list-style-type: none"> Based on the consolidated external audit of project accounts for FY 2016-2017 for the ongoing third small towns project submitted by DWSS, it appears that TDF has not complied with the financial covenants. 	TDF to ensure timely resolution of any audit issues and compliance with mitigation measures.
8. Reporting and monitoring	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> TDF prepares financial statement of the entity and project accounts using MBS and spreadsheets. This procedure will be followed for the project. 	Not applicable.
9. Information system	<p style="text-align: center;">Low</p> <ul style="list-style-type: none"> TDF's MBS and MIS provide required information for financial reporting and management decision. 	Not applicable.
Overall Control Risk	<p style="text-align: center;">Moderate</p> <p>Some financial management risks are recognized, but most of them are not substantial. Understaffing of accounts section of TDF may delay the timely and effective implementation of the project. Government of Nepal and TDF needs to commit the full staffing of accounts section of TDF to timely implement the project.</p>	

ADB = Asian Development Bank, DTCO = District Treasury Controller Office, DWSS = Department of Water Supply and Sewerage, EA = Executing Agency, FCGO = Financial Comptroller General's Office, FY = Fiscal Year, MBS = Micro Banking Software, MIS = Management Information System, MOWS = Ministry of Water Supply and Sanitation, OAG = Office of the Auditor General, PMO = Project Management Office, TDF = Town Development Fund, STWSSP = Small Town Water Supply and Sanitation Project, UWSSP = Urban Water Supply and Sanitation Project, WUSC = Water Users and Sanitation Committee.

Source: Asian Development Bank.

VII. STRENGTHS AND WEAKNESSES

49. **Strengths.** A significant strength of the financial management system of DWSS, PMO, and TDF is that they have considerable experience handling ADB funded projects with substantial values. DWSS, PMO, and TDF have also been implementing the ongoing third small towns project funded by ADB.

50. **Weakness.** The following weaknesses in the financial management system have been identified and need addressing:

- (i) delays in fully establishment of dedicated WUSCs with qualified staff may hamper the timely and effective implementation;
- (ii) lack of training to the new accounting staff of PMO may cause delays in preparing day-to-day financial management; and
- (iii) inadequate staff in the finance section of TDF may hamper the timely preparation and submission of periodic financial reports.

VIII. ACTION PLANS

51. Table 4 sets out the actions that ADB and the government agreed as an action plan to address issues that the financial management assessment identified in executing agency and implementing agencies.

Table 4: Action Plan to Address Financial Management Assessment Issues

Area	Current scenario	Risk	Mitigation measures	Responsibility	Target Date
Full establishment of dedicated WUSCs	WUSCs have not been fully established yet.	Delays in full establishment of dedicated WUSCs may hamper the timely and effective implementation.	Commitment of Government of Nepal and DWSS to ensure the full establishment of WUSCs in a timely manner.	MOWS, DWSS, WUSCs	before loan signing
Training new staff	Staffs of PMO are transferred every 2 years.	New staff may have insufficient knowledge of ADB procedures, which may cause delays in the day-to-day financial management.	Extending full training and capacity building support with the help of a team of consultants to enhance the financial management capacity of PMO.	MOWS, DWSS	before loan effectiveness onwards
Staffing	There are vacancies in the finance section of TDF.	This may hamper the timely preparation and submission of periodic financial reports.	Appointing or recruiting qualified staff to fill the vacant positions in the finance section of TDF.	MOF, TDF	before loan signing
TDF external audit of project accounts and compliance	Based on the consolidated external audit of project	Financial management weakness of TDF	TDF to ensure timely resolution of any audit issues and	TDF	before loan effectiveness onwards

Area	Current scenario	Risk	Mitigation measures	Responsibility	Target Date
with financial covenants	accounts for FY 2016-2017 for the ongoing third small towns project submitted by DWSS, it appears that TDF has not complied with the financial covenants.		compliance with mitigation measures.		

ADB = Asian Development Bank, DWSS = Department of Water Supply and Sewerage, MOF = Ministry of Finance, MOWS = Ministry of Water Supply, PMO = project management office, TDF = Town Development Fund, WUSC = Water Users and Sanitation Committee
Source: Asian Development Bank.